Internal Revenue Service
memorandum

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date: JUN 19 1986

to: District Counsel, Los Angeles CC:LOS

from: Director, Tax Litigation Division CC:TL

subject: [redacted], Taxpayer

This is in response to your request for technical advice dated December 13, 1985.

Issues:

1. Whether the taxpayer's [redacted] and [redacted] transfers to the partnership designed to fix or freeze the value of the donor's interest consituted transfers subject to the gift tax. 2511.00-00.

2. Whether the taxpayer has made a gift subject to the gift tax by failing to exercise her right to dissolve the partnership and withdraw her capital contribution. 2511.00-00.

3. Whether a failure to file penalty under I.R.C. 6651(a) should be imposed with regard to the [redacted] transfer. 6651.03-00.

Conclusions:

1. & 2. When a taxpayer makes a capital contribution to a family partnership in exchange for a partnership interest the Service may assert a gift tax only at the time of contribution and only if the value of the capital contributed exceeds the value of the partnership interest received in exchange. See Rev. Rul. 83-120, 1983-2 C.B. 170.

3. Even if it is determined that the taxpayer has made a taxable gift under the analysis noted above, a failure-to-file penalty should not be asserted under I.R.C. § 6651(a).

Facts

The taxpayer, [redacted] is a resident of Oregon. On [redacted], a limited partnership, the [redacted], was formed by [redacted], Trustee of the [redacted], dated [redacted]; [redacted], Trustee of the [redacted] dated [redacted];

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and [redacted], Trustee of the [redacted] dated [redacted], as General Partners; and [redacted] as Trustee of the [redacted] dated [redacted], for the benefit of [redacted] as a Limited Partner.

The [redacted], the [redacted], and the [redacted] are revocable inter-vivos trusts established by the respective trustees with their own funds. [redacted], [redacted], and [redacted] are children of the taxpayer.

At the time the partnership was formed, it was initially agreed that the taxpayer would contribute $[redacted] to the partnership, and the other partners would each contribute $[redacted], for a total capitalization of $[redacted]

At the time the partnership was formed, the taxpayer contributed only $[redacted] to the partnership, $[redacted] less than she had agreed to contribute. Her sons insisted that she contribute the full amount in accordance with the original agreement. The taxpayer initially refused, but after substantial negotiation, she finally agreed in [redacted] to contribute an additional $[redacted] if each of the other partners would agree to contribute $[redacted], bringing their total contribution in the aggregate to $[redacted] and the taxpayer's to $[redacted].

The assets of the partnership consist of stocks and bonds and two limited real estate partnerships.

Article [redacted] of the Partnership Agreement specifies a partnership term of 50 years "unless earlier dissolved."

Article [redacted] of the agreement establishes two classes of partners, Class A and Class B. The taxpayer is designated as the only Class A partner, and [redacted], [redacted], and The [redacted] are designated as Class B partners.

Under Article [redacted], any gains realized on the sale of assets contributed to the partnership are allocated to the partners as follows:

(1) [redacted]

(2) [redacted]

Article [redacted] provides that all net losses are allocated solely to the Class B partners to the extent of the positive balance in the capital account of the Class B partners. Any unallocated loss is then allocated to the Class A partner.

Article [redacted] of the Partnership Agreement provides for the allocation and distribution of net profits. All net profits 1/ for each fiscal year are allocated first to the Class A partner until the net profits allocated to her equal [redacted] percent of her contributed capital. In the event the net profits for the year are less than [redacted] percent of the contributed capital, then [redacted] percent of the income is to be allocated to the Class A partner. If the amount paid the Class A partner is less than [redacted] percent of her contributed capital, then the difference between the amount actually paid and [redacted] percent of her contributed capital is designated as an income deficiency. The Class A partner must be paid all accrued income deficiencies before any income can be allocated to the Class B partners.

In the event partnership profits exceed the amount allocated to the Class A partner, the excess is paid to the Class B partners up to an amount equal to [redacted] percent of the Class B partners' contributed capital. Any additional profits are allocated [redacted] percent to the Class A partner and [redacted] percent to the Class B partners.

Article [redacted] specifies the method for determining the value of each partner's interest. This valuation is to be utilized to determine the purchase price of the interest in the event a partner dies and the surviving partners exercise an option to purchase the interest under Article [redacted], or a partner desires to transfer the interest, and the remaining partners exercise their option to purchase the interest under Article [redacted]. Further, under Article [redacted], this valuation method is to be utilized to determine the distributions to the partners in the event the partnership is dissolved, either by a vote of the general partners or by operation of law.

Generally, under Article [redacted], the value of the Class A partner's interest is the sum of the Class A partner's capital account, plus any debts owed the Class A partner and any accrued net profits for the current fiscal year. The value of the Class B partner's interest is the fair market value of the partnership assets less the value of the Class A partner's interest.

1/ Net profits are defined to exclude amounts deducted for depreciation, depletion or amortization on the partnership's tax return.

Under Article [redacted], each general partner is to participate in the control, management, and direction of the partnership. Each general partner's vote is to be in proportion to his or her interest in the partnership's original capital.

The partnership scheme is designed to ensure that any appreciation generated by the assets transferred to the partnership by the taxpayer inures to the benefit of the other partners. Thus, on the taxpayer's death, an amount equal to her original contribution to the partnership will be includible in her gross estate. Any appreciation in those assets will pass to the remaining partners free of any transfer tax.

Articles [redacted] and [redacted] effectuate this "estate freeze". Under Article [redacted], if any partnership asset is sold, that portion of the amount realized attributable to post-contribution appreciation is allocated entirely to the Class B partners. Thus, the taxpayer's capital account will generally, remain fixed at the amount of the initial contribution.

Further, this "frozen" value of the taxpayer's capital account fixes the amount the taxpayer can realize on a dissolution of the partnership (Article [redacted]); sets the sales price of the interest under a right of first refusal should the taxpayer desire to sell the interest (Article [redacted]); and fixes the sales price of the interest under the option to purchase accorded the remaining partners on the taxpayer's death (Article [redacted]. These provisions and restrictions arguably limit the includible estate tax value of the interest to the taxpayer's "frozen" capital account. 2/ Thus, any appreciation in the assets transferred to the partnership could potentially pass tax-free to the other partners.

DISCUSSION - Issues 1 and 2

I.R.C. § 2501 imposes a tax on the transfer of property by gift. The gift tax applies, under the provisions of section 2511 and Treas. Reg. § 25.2511-1(a), whether the transfer is in trust or otherwise and whether the gift is direct or indirect. Thus, the gift tax applies to all transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed. See Treas. Reg. § 25.2511-1(c).

2/ In St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982), the court concluded that a restrictive agreement may fix the value of property for estate tax purposes only if the agreement had a bona fide business purpose and it was not used as a tax avoidance testamentary device. See Treas. Reg. § 20.2031-2(h). In the instant case, it is arguable that the restrictive agreement, indeed the entire transaction, was entered into primarily to avoid estate taxes. Thus, the restrictive agreement may not necessarily fix the estate tax value of the interest.

Treas. Reg. § 25.2511-2 further provides that a gift becomes complete and thus subject to the gift tax at such time as the donor has so parted with dominion and control as to leave the donor with no power to change its disposition. See, e.g., Robinette v. Helvering, 318 U.S. 184 (1943).

I.R.C. § 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

Rev. Rul. 83-120, 1982-2 C.B. 170, considers several situations closely analogous to the partnership capital freeze situation presented in the instant case. The revenue ruling considers the application of the gift to various corporate recapitalizations pursuant to which a common stockholder exchanges his common stock for preferred stock in the corporation. Generally, the exchanging shareholder's child continues, or becomes, a common stockholder in the corporation. The revenue ruling acknowledges that "One of the frequent objectives of the type of transaction . . . is the transfer of the potential appreciation of an individual's stock interest in a corporation to relatives at a nominal or small gift tax cost." The revenue ruling views the transaction as a completed gift at the time of the exchange. Thus, in determining whether a gift tax is applicable, the ruling focuses on whether the transferor has received adequate consideration for the stock interest relinquished. Although the revenue ruling acknowledges that the transferor has in effect transferred the potential appreciation inherent in his stock interest, there is no assertion that this potential appreciation may in some way be subjected to a transfer tax.

We believe this same analysis should be applied to the formation of the family partnership involved in the instant case. Thus, we believe the taxpayer's investment in the partnership constituted a completed transaction at the time the interest was acquired. The application of the gift tax should be determined at that time. If the taxpayer's capital contributions exceed the value of her partnership interest, the difference represents an indirect gratuitous transfer to the taxpayer's children upon which a gift tax may be imposed. See, e.g., Treas. Reg. § 25.2511-1(h)(1). See also Kincaid v. United States, 682 F.2d 863 (5th Cir. 1982); Baumer v. United States, 580 F.2d 863 (5th Cir. 1978); Heringer v. Commissioner, 235 F.2d 149 (9th Cir. 1956).

It has been suggested that a subsequent gift tax may be imposed on the basis that the taxpayer, as a result of her position as a controlling general partner, could control the income earned by the partnership and therefore made a gift by selecting investments that might generate a low yield and high appreciation.

We do not believe a gift tax can be asserted on the basis that the taxpayer, through her investment decisions, relinquished income or appreciation. The partner's relationship in a partnership is fiduciary in character. Thus, the partners are obligated to exercise good faith in their activities with respect to partnership affairs. See 68 C.J.S. § 76. Generally, the Service has been unsuccessful in arguing that an individual subject to fiduciary restraints in a business setting can exercise control that will subject property to transfer tax. See e.g., United States v. Byrum, 408 U.S. 125 (1972); Estate of Gilman v. Commissioner, 65 T.C. 296 (1975), aff'd per curiam, 547 F.2d 32 (2d Cir. 1977), nonacq. 1978-2 C.B. 3; Rev. Rul. 81-15, 1981-1 C.B. 457.

In addition, we believe any benefits relinquished by the taxpayer, and any benefits derived by the Class B shareholders as a result of the taxpayer's investment decisions, would be speculative at best. Indeed, the taxpayer's decision to invest the partnership assets in low yielding investments might arguably operate to the detriment of herself, as well as the Class B partners since the Class B partners' right to income would be adversely affected as well. Thus, we do not believe we can successfully assert that a transfer has occurred, based on the taxpayer's investment of the partnership assets pursuant to her fiduciary position as the controlling general partner.

Further, the taxpayer's interest is analogous to a preferred stock interest. By definition, all appreciation in excess of the preferred interest requirements belong to the other members of the enterprise by reason of their initial acquisition of a share in the enterprise. We believe the partnership freeze should be tested on the same principles as a corporate freeze. In the instant case, the taxpayer has virtually imitated a corporate freeze. The Service has recognized the legitimacy of the corporate freeze, if properly accomplished, and, by implication, has rejected the imposition of a gift tax based on the relinquishment, on a continuing basis, of appreciation or income. See Rev. Rul. 83-120, supra. In view of the similarity in the nature of the two interests, the result should be the same whether the partnership mechanism or corporate mechanism is employed.

Thus, we believe that a gift tax may be asserted in the instant case only in the years of transfer. The measure of the gift is the extent (if any) that the value of the property transferred to the partnership exceeds the partnership interest the taxpayer received in exchange. 3/

3/ In view of our determination that the transaction was complete and thus the gift tax can be asserted only in years of transfer, and may not be imposed on a continuing basis, we find it unnecessary to discuss Dickman v. Commissioner, 465 U.S. 330 (1984). Suffice it to say, we do not believe Dickman would apply in a partnership investment scenario.

The taxpayer's representative has argued that even if the taxpayer's partnership interest was worth less than the assets she transferred in exchange, no gift can be asserted because under the partnership agreement, the taxpayer could unilaterally liquidate the partnership and thus reacquire the transferred assets. Thus, the taxpayer concludes that the taxpayer never relinquished dominion and control over the assets and thus has not made a completed gift. See Treas. Reg. § 25.2511-2. Assuming arguendo that the taxpayer could liquidate the partnership (a matter discussed more fully below) we do not believe that this liquidation power is analogous to retained dominion and control over the transferred property.

A partnership interest generally will exist during the life of the partnership; whatever interests are created are determined at the time the partnership agreement is entered into. Subsequently, each partnership interest continues subject to the original partnership agreement unless further modified. The right of a controlling partner to dissolve the partnership has never been thought to constitute retained dominion and control over such partner's capital contribution so as to defeat a gift. The right of a controlling partner to dissolve a partnership is analogous to the right of a controlling shareholder to dissolve a corporation. Thus, the argument that the right to dissolve is equivalent to retained dominion and control, if carried to an extreme, would lead to the conclusion that no gift of stock by a controlling shareholder, no matter how gratuitous, could ever give rise to gift in year of transfer if the controlling shareholder had the right to liquidate. Again, by implication, the Service has never adopted this position. See Rev. Rul. 83-120, supra.

Further, under the facts presented in the instant case we doubt whether the taxpayer could unilaterally dissolve the partnership. Generally, under Oregon law, unless the partnership agreement provides otherwise, a partnership with a specified term can only be dissolved by the consent of all the partners. O.R.S. § 68.530(1)(c). See also, Hunter v. Straube, 543 P.2d 278(S. Ct. Or. 1975). As noted above, Article [redacted] of the partnership agreement specifies a term of 50 years.

Nonetheless, the taxpayer argues first that under O.R.S. § 68.530 the taxpayer could unilaterally dissolve the partnership. This section provides that the dissolution of the partnership can be caused by "(2) In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time."

Generally, under this section any partner has the power to dissolve the partnership. However, if the partner does dissolve the partnership in contravention of the partnership agreement, the moving partner will be liable for damages for breach of the partnership agreement. See, Hunter v. Straube, 543 P.2d at 282. Thus, this provision does not give the partner the right to dissolve the partnership, but merely the power any participant has to breach his contractual obligations and suffer the consequences. We do not believe this is the kind of power that should be taken into account for tax purposes in determining whether the partner has the right to unilaterally dissolve the partnership and recover her capital contribution.

The Taxpayer's next argument references the terms of the partnership agreement. Article [redacted] of the partnership agreement, in discussing the order of distribution of partnership assets in the event of a liquidation or distribution provides, "[redacted]" Article [redacted] of the agreement allows each general partner to participate in the control, management and direction of the business and vote in proportion to his or her capital account. The taxpayer thus argues that, under Article [redacted], the partnership can be dissolved and, under Article [redacted], the taxpayer's vote will control.

Generally, a partnership agreement is subject to the same rules of construction as are other written agreements. Thus, generally, a court will construe the agreement to carry out the intent of the parties, and the intention of the parties must be ascertained by consideration of the agreement as a whole. See generally, 68 C.J.S. § 77.

In the instant case, it is clear that Article [redacted] was intended primarily to provide for an order of distribution in the event of a liquidation, rather than to provide substantive rules regarding when and under what circumstances the partnership could be dissolved. Thus, Article [redacted] should not be construed as authorizing the unilateral dissolution of the partnership.

Indeed, considering the nature of the partnership it is unlikely that the minority partners would want to give such control to the taxpayer. As noted above, any losses are first allocated to the Class B partners to the extent of their capital accounts. Thus, if the partnership incurs losses, charged to the Class B partners, the taxpayer can theoretically defer liquidation, allow losses to be charged to the Class B partners and then liquidate when her assets are in jeopardy, thus wiping out the Class B partners. It is unlikely that any individual would invest funds under circumstances such that their investment could be eliminated by one partner's unilateral decision to liquidate.

Thus, we believe that a review of the agreement as a whole (including the fact that the instrument provides for a specified term) reveals that it was not the intent of the parties to grant the taxpayer the unilateral right to liquidate the partnership.

We further note, that in the corporate area, the courts have recognized that even if a controlling shareholder has the power to liquidate, such power can only be exercised under strict fiduciary standards with due regard to the minority interests. See, e.g., Estate of Curry v. United States, 702 F.2d 741 (8th Cir. 1983). Since, as noted above, a partner's relationship in a partnership is fiduciary in nature, the taxpayer in the instant case would be operating under the same strict standards.

The taxpayer has also argued that even if the assets the taxpayer transferred to the partnership exceeded the value of the partnership interest she acquired in exchange, a gift tax should, in any event, not be asserted. Taxpayer contends that the transaction comes within the ordinary course of business exception to the gift tax contained in Treas. Reg. § 25.2512-8. Specifically, this regulation provides that:

> A sale, exchange or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth.

Intra-family transactions are always subject to special scrutiny since the genuineness of the transaction is necessarily suspect because of the family relationship. See Kincaid v. United States, supra; Baumer v. United States, supra; Fehrs v. United States, 80-1 U.S.T.C. 13,348 (Ct. Cl. 1980).

In the instant case, there were arguably business reasons that could be cited for the taxpayer's investment in the partnership. For example, taxpayer arguably wanted to ensure a relatively stable rate of return and also ensure against any erosion of principal. Nonetheless, these business reasons for the transaction would not negate the imposition of the gift tax if, in fact, the taxpayer transferred assets to the partnership for less than adequate consideration. That is, while there may have been business reasons for transferring the assets to the partnership, there would be no business reason for the acceptance of a less than adequate consideration for the exchange. See, Kincaid v. Commissioner, 682 F.2d at 1226.

To summarize our conclusion, the gift tax should be imposed in the instant case only if it is determined that value of the assets transferred by the taxpayer to the partnership exceeded the value of the partnership interest she received in exchange. This determination will require a valuation of the partnership interest.

This conclusion requires an evaluation of factors to be considered in determining the value of the partnership interest on the date of transfer. Here we have a readily available analogy in Rev. Rul. 83-120, supra, which analyzes factors to be considered in determining the value of preferred and common stock. The revenue ruling specifies that all the facts and circumstances should be considered, including voting rights, redemption privileges, and security for preferred stock. By analogy, in the instant case, the fact that the children will receive all future appreciation tends to depress the value of the taxpayer's interests and enhance the value of the children's interest. Similarily, the fact that no prior "income deficiencies" are included in valuing the taxpayer's interest for transfer or liquidation purposes would negatively affect the value of the taxpayer's interest. On the other hand, the fact that the taxpayer's interest carries voting control would tend to make the interest more valuable.

Regarding a determination of the adequacy of the return, we note that the Estate Tax Attorney, in his analysis, compared the partnership return to that of a long term treasury bill. We believe government debt instruments do not serve as appropriate comparables. Under Rev. Rul. 83-120, the inquiry should be whether the partnership interest is earning an adequate rate of return when compared with equity interests in similar enterprises that are created by unrelated parties dealing at arm's length. A government debt instrument is too dissimilar from an equity interest in an enterprise to be used as a comparison.

DISCUSSION - Issue 3

On audit, the Estate Tax Attorney asserted a penalty for failure to file and pay the gift tax liability under I.R.C. § 6651(a)(1) for the [redacted] calendar year.

The facts as we understand them are that at the time the partnership agreement was executed in [redacted], the parties had agreed that the taxpayer would contribute $[redacted] to the partnership. On her gift tax return filed for the calendar quarter ending [redacted], the taxpayer reported a capital contribution of $[redacted] to the partnership in exchange for the Class A partnership interest. Apparently, the taxpayer asserted that no gift tax was due on the transaction.

In fact, the taxpayer contributed only $[redacted] to the partnership in [redacted]. Subsequently, in [redacted] the taxpayer contributed an additional $[redacted] to the partnership. However, no return was filed for [redacted].

Generally, under section 6651(a), the penalty will not be imposed if the failure to file is due to reasonable cause and not willful neglect. See Estate of Lang v. Commissioner, 613 F.2d 770 (9th Cir. 1980); Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970).

In the instant case, the Service may assert (depending on the outcome of the valuation determination) that taxpayer made a completed transfer in [redacted] and a second completed transfer in [redacted]. We do not believe it is appropriate to impose any penalties in this case. The taxpayer fully informed the Service of the transaction in [redacted], noting that her contributions totalled $[redacted]. Since she had already reported the transaction in total in [redacted], we believe her failure to file a return in [redacted], when a portion of the contribution previously reported on the [redacted] return was actually made, should be considered due to reasonable cause. Thus, we do not believe any penalties should be asserted in this case.

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